

Editorials/Op-Ed

Fork in the road

By John Rutledge

With the Federal Reserve's latest rate increase, investors are wondering if the stock market rally that began in mid-August is a head fake and will stall. The answer is no. In fact, the stock market rally has little to do with the Fed. It's the tax rates.

The election in November is a black-and-white choice in terms of economic policies. The key economic difference between the two candidates is their position on tax rates. If President Bush is re-elected, he's almost certain to go back to Congress a second time and ask for a zero dividend tax rate. The dividend tax rate for most people is now 15 percent.

Sen. John Kerry is attacking budget deficits. If elected, he is very likely to raise the dividend tax rate back up to nearly 40 percent. So investors are looking at a real fork in the road where rates a year from today could be either zero percent or around 40 percent. Those numbers have very different implications for the stock market.

There are also differences between how the two candidates view the personal-income tax rate. Mr. Bush is in favor of lowering income-tax rates. Mr. Kerry has indicated he wants to raise income tax rates on those

taxpayers making more than \$80,000 a year. But the truth is I expect Mr. Kerry will be looking to raise the top marginal tax rate on top earners as well.

Why does that matter? Because 80 percent of taxes collected at the top tax rate are paid by small business owners whose businesses are organized as proprietorships. The profits of the business flow through to the owners' personal taxes. They don't generally have financial statements and they don't discriminate between their own income and the working capital of the business. So the top personal tax rate is a tax on capital for private business.

Although there were other positive things that happened, the dividend tax cut deserves the lion's share of credit for the stock market gains of the last two years. Indeed, when the cuts were passed the Dow was at about 7,500. Today, it's hovering around 10,200 — an increase in the value of shares in the market of more than \$2 trillion.

Two years ago, I did an analysis that showed that when dividend taxes are reduced investors buy dividend-paying stock and leave non-dividend paying assets, such as bonds, real estate and non dividend paying stocks. Assuming both classes reap a 10 percent after-tax return, lowering the dividend-tax rate means more money goes into the pockets of

investors who own dividend paying stocks.

If Mr. Bush is re-elected and the dividend tax rate drops to zero, I predict that's good for another 10 percent increase in market value within six to 12 months. If Mr. Kerry is elected, you'd give back all those gains secured over the past two years. The stock market would drop by at least 10 percent.

The good news is that the gains from the dividend tax cut are still happening. Think of the dividend tax cut as a bunker-buster — a bomb with two warheads that explodes and then explodes again. The first explosion causes investors to change their portfolios as described above. That re-prices all existing stocks and is worth that 10 percent increase.

The second warhead is potentially much larger, but will take more time to unfold. It is the increase in value of companies in the stock market that happens as they adapt their behavior to the new tax environment. They're able to finance operations with dividend-paying stock instead of taking on debt for which they pay interest.

The bad news is that Mr. Kerry would return us to the days when companies financed operations with debt, when they hoarded cash rather than pay it to shareholders as dividends. According to the American Shareholders Association, the number of S&P companies paying a dividend declined from 469 in 1980 to 351 in 2002. In 2003 alone, in response to the dividend tax cut, 21 companies initiated a dividend.

The most visible result was Microsoft's announcement of its first ever dividend in January 2003. Since then, Microsoft has raised the

dividend, and in July it paid a special dividend of \$3 per share equal to \$32 billion, the largest dividend payout in corporate history.

In spite of all that companies have done to adapt the dividend-tax cuts, they're still holding back on the \$1.5 trillion in cash they could distribute to shareholders. They don't want to put that piece of meat into the shareholder's mouth and jerk it out six months later, when Mr. Kerry could erase the dividend-tax cuts.

There are two kinds of waiting going on today. Investors are waiting to see what the dividend-tax rate will be when they value shares, and managers are waiting to see what the dividend tax rate will be before making decisions about payouts, special dividends and capital structure. They won't have to wait much longer.

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